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James L. Kroeker, Vice Chairman
Gary R. Buesser, Board Member
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

VIA EMAIL

Dear Messrs. Kroeker and Buesser:

I would like to propose that the Board consider instituting disclosure standards and guidelines regarding indicators of the health of a company's customer base. These standards and guidelines would serve several important purposes:

- Provide information necessary for more accurate valuation of a company by investors,
- Improve the consistency, reliability, transparency, and auditability of disclosures already in common practice, and
- Enable the above without imposing undue burden on reporting entities and the preparers of financial statements, in terms of either time or cost.

Prior efforts have explored requiring companies to report the value of customer relationships as an intangible asset on the balance sheet. It has been determined that this would impose undue cost and effort on reporting companies. It would also introduce undesirable uncertainty and opacity through differing valuation methodologies and assumptions. To avoid this complexity, companies should disclose just a few metrics that most already have at-hand, and which a growing number already provide in some way today. This will allow investors to apply their own valuation methodologies and assumptions, enhancing their projections and estimates.

Background

Today, a growing number of companies disclose information about their customers. This includes both large, established firms, and new firms preparing for or just following an IPO.

For example, companies in the telecommunications industry, such as Verizon and AT&T, regularly disclose data for each segment of their business, including:

- Total wireless customers
- Video connections
- Broadband connections

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In many cases, such data is further broken down by product class (for example, IP versus DSL lines, or Satellite versus U-verse). Moreover, these companies also disclose the number of net new customers added in each of the product classes during the period. See, for example: http://verizon.api.edgar-online.com/EFX_dll/EdgarPro.dll?FetchFilingConvPDF1?SessionID=bpBSUbcdhyUgXx5&ID=13233286.

These disclosures, included in the Management Discussion and Analysis section of the annual and other periodic reports, have become common practice in telecommunications, because they provide important information to investors, allowing them to improve their estimates and projections of future performance, and thus improving their ability to project future operating cash flows.

Similarly, many younger companies that are investing heavily in growing their businesses disclose similar information in S-1 Registration filings, or in their own periodic earnings reports. For example, Slack Technologies, in its S-1 Registration filing disclosed information about its customers, including:

- Number of paid customers
- Number of paid customers generating greater than $100,000 per year
- Net dollar retention rate
- A chart showing the annual recurring revenue derived from successive cohorts of customers acquired over the prior four years

(Source: https://www.sec.gov/Archives/edgar/data/1764925/000162828019004786/slacks-1.htm#sF35C8C28EA1ADA540B93567D8C4930D5)

A review I conducted of roughly 309 companies that were preparing for public stock offerings in 2018 showed that nearly one-quarter of them included non-GAAP metrics such as active customer count, new customers acquired, purchases per customer, or revenue per new-customer cohort. Such companies often provide this sort of information in an attempt to demonstrate to potential investors (and/or current investors, in the case of companies that have already issued shares to the public) that, despite current period losses, the company is creating future value in the form of customer relationships that will ultimately make the company profitable.

All of these disclosures, however, are currently voluntary and at the discretion of management. As a result, several problems arise. For example:

- Each company is left to decide what it deems relevant to disclose. Few rules define which metrics companies should disclose, so different companies in the same industry often choose to make different information available.
- Different companies in the same business may use differing definitions for certain metrics. Worse still, these definitions are opaque – there is no requirement to disclose methodology and no standard methodology on which to rely. As a result, comparability across companies is often problematic.
- Companies may choose, at any time, to discontinue disclosure of any metric they fear will not look good to investors. While investors often regard such changes in disclosure

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with disdain, investors have no recourse if the company chooses to stop providing a particular item.

Outside of a few industries such as telecommunications, investors must sort through a patchwork of different metrics across different companies, and little basis for comparison.

In a few cases, companies have quietly changed the basis for calculating some of the customer metrics disclosed. Not only has this resulted in confusion among investors and other constituents relying on these disclosures, but it has occasionally led to legal or regulatory action. For example, the SEC recently hit Comscore, Inc. with an enforcement action, part of which pertained to alleged "false or misleading disclosures regarding…inflated customer totals that falsely conveyed a consistent increase in the number of net new customers added." At issue were "multiple changes to the methodology by which the quarterly customer count was calculated…[which were] neither applied retroactively nor disclosed to the public." (Source: https://www.sec.gov/litigation/admin/2019/33-10692.pdf)

While it may not be of direct concern to the Board, other pernicious effects result from this state of affairs. Based on several decades of experience advising senior executives of public companies, my colleagues and I have come to believe that some significant portion of "short-termism" results directly from this lack of transparency. Company leaders feel tremendous pressure to meet the earnings expectations of analysts and investors each quarter. Too frequently, short term factors, such as interest rate movements, changes in input prices, or other temporary exogenous factors, put pressure on management teams to sacrifice customer relationships to meet near-term earnings targets. They impose onerous "nuisance fees," reduce service levels, and cut corners on product quality, for example. In doing so, they anger customers, erode their trust, undermine their brand reputation, and reduce the long-term economic value of the customer base.

Investors would generally prefer that companies make and sustain investments to grow the value of the customer base. But under today's reporting and disclosure rules, they have little reliable evidence that these investments will result in sustainable, profitable growth. This lack of reliable customer data places much more emphasis on short-term earnings, with little prospect of valuing long-term customer relationships. Therefore, investors — with good reason — continue to pressure management to deliver near-term earnings, even if it might come at the expense of long-term growth and increased value of the firm.

It is telling that across more than two dozen industries, just over one-third of the companies that have sustained customer loyalty leadership in their industries (as measured by JD Power awards, ACSI satisfaction scores, or Net Promoter Scores collected by Bain & Company) are independent and publicly-traded. Two-thirds of the enduring loyalty leaders in their industries are owned privately (whether by the founders, by customers, or by employees) or are publicly-traded, but controlled by the founder or the founder's family. Such companies include iconic loyalty leaders like USAA, Vanguard, Amazon, Aldi (Trader Joes), and Chick-fil-A.

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Proposal

I propose that the Board consider requiring most companies to disclose the following information about the health of their customer base regularly. I have broken this proposal into three levels of disclosure. The first would be the absolute minimum required by investors to inform valuation. The others may require more effort, but also enhance valuation.

Level 1: Minimum required to enhance valuation models:

- Customer count
  - Number of gross new customers acquired during the preceding 12 months
  - Number of active new customers remaining at period-end
  - Number of active tenured customers (tenured customers are those who have been customers for 12 months or more; active customers have made a purchase in the past year)
- Revenue
  - Revenue from all customers
  - Revenue from all tenured customers
- Purchase velocity
  - Number of purchase transactions completed by new customers during the period
  - Number of purchase transactions completed by tenured customers during the period

Level 2: The above, plus:

- Customer count
  - Active customers remaining at period-end from each cohort (group of customers acquired during a given period, such as a year)
- Revenue breakdown
  - Revenue by cohort
- Costs
  - Customer acquisition cost – the total cost of acquiring customers during the preceding 12 months, including marketing, sales, initial account set-up, etc.

Level 3: The above, plus

- Customer count
  - Active customers remaining at period-end who were counted among the top 20% by revenue during the prior period
- Revenue breakdown
  - Revenue for the top 20% of customers by revenue
  - Median value per purchase transaction
- Purchase velocity
  - Number of purchase transactions completed by the top 20% of customers by revenue during the period

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In addition, if a company choses to disclose Net Promoter, customer satisfaction, or other survey-derived scores or indications customer base health, they should also be required to disclose the methodology by which such scores were created. In this way investors can evaluate their significance. For example, if sourced from a third party, such as JD Power, or American Customer Satisfaction Index, this should be noted.

Investor perspective

The above items, combined with existing reporting and disclosure standards and rules, provide sufficient data for analysts and investors to enhance their projections of future cash flows for most companies.

While investors have long relied on disclosures of customer data under certain circumstance, demand for such disclosures is growing. Research published by Peter Fader and Daniel McCarthy provides a methodology for using the above metrics to create surprisingly reliable projections of future revenues and margins. In many cases, these projections add significant predictive value to traditional discounted cash flow valuation models, because they apply a customer-based lens to revenue projections that would not be possible without adequate disclosure of customer counts, revenue, and purchase velocity in cohorts of customers acquired during each period. (See: McCarthy, Daniel; Fader, Peter (2018). "Customer-Based Corporate Valuation for Publicly Traded Non-Contractual Firms". Journal of Marketing Research, 55(5), 617-635. Link (download) and McCarthy, Daniel; Fader, Peter; Hardie, Bruce (2017). "Valuing Subscription-Based Businesses Using Publicly Disclosed Customer Data". Journal of Marketing, 81(1), 17-35. Link (download).)

A growing number of investors now use methodologies like this to create what they believe to be significantly more accurate projections, and thus more accurate valuations. Three examples of such analysis include Lyft, Wayfair, and Blue Apron (see links).

Considerations

I would anticipate several issues, concerns, and challenges to implementing standards and requirements like these. Among the issues:

- Very few investors request or demand such data today. The techniques for incorporating customer health indicators into future cash flow projections are relatively new. While usage is growing, the majority of investors do not use these models today. This could be seen as evidence that such information is not important enough to investors relative to the cost and effort required to provide it.
- In some business models, very few of the customers can be identified. For example, in the fast food or restaurant industry, it is rare to be able to identify more than a handful individual customers making purchases. Similarly, retail convenience stores rarely have the ability to identify customers, and would not be exempt from such customer-level reporting. When these companies operate rewards programs, however, in which customers agree to identify themselves at the point of purchase in exchange for some form of reward, the basis for disclosure should be the participants in the program, and

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the revenue from these customers should be distinguished from revenue that comes from unidentifiable customers.

- In some cases, determining the basis or standards for disclosure may require some effort. In the telecommunications industry, for example, disclosures generally focus on individual accounts. They do not appear to make an effort to report cross-product ownership. So a long-time ISP customer who now adds a mobile phone relationship will be shown as an existing customer for the ISP, and a new customer for the mobile business. It is possible that other industries or business models may require different conventions for disclosure of customer metrics. The development of standards for defining the unit of disclosure may require additional work.
- Some companies may argue that the cost and effort required place an undue burden on them. It is possible that some companies do not have ready sources of reliable customer counts, new customer acquisition data, or revenue by customer cohort today. While I would argue that a failure to have such data for most companies would represent a failure of management, it is reasonable to assume that data quality and other issues could make it difficult to report reliably for some companies — at least temporarily.
- Some management teams may assert that this sort of data is proprietary and disclosing it would reveal too much information to competitors. Such arguments, however, don't hold up well in the face of voluntary disclosures by companies trying to woo investors, or by companies in some industries for which it is now common practice.
- Companies that perform poorly on such metrics are likely to resist consistent, required disclosure. While these disclosures should reward management teams for making smart investments to grow customer value, they will necessarily punish companies that show weakness in customer value growth relative to their peer group.
- These disclosures may not materially improve valuation for companies in some industries or business models. It can be argued that for companies primarily in the oil and gas exploration, production and refining businesses, for example, the health of a company's customer relationships has little bearing on the future cash flows of the firm relative to other factors, such as macroeconomic growth, trade restrictions, or supply shocks.

It will be important to anticipate and address these and other potential considerations and challenges. I believe many of these are quite easy to address. A few, however, will require some additional discussion and study. For example, work will need to be done determining for which industries or business models such disclosure requirements should be waived, or how to treat situations in which a company has multiple relationships with a single customer.

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Summary
Providing investors and other users of financial statements additional transparency, consistency and reliability with respect to the health and value of a company's customer relationships has become increasingly important, and increasingly practical over the past several decades. I believe FASB should take a lead in helping define the standards and requirements for customer data disclosure. This will enable investors to value companies more accurately, and, in cases where a company is making good investments in growing the value of its customer relationships, will help convert quarterly earnings reporting from a source of "short-termism" into a source of confidence and support for long-term value creation. Further, it will do so in a way that minimizes effort and costs on reporting companies.

I would be more than happy to discuss this topic in more detail, should you find that valuable.

Best regards,

RGMarkey Jr

Rob Markey
Partner, Director and Vice President
Bain & Company, Inc.